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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Regulation of Local Exchange Carriers	)	CC Docket No. 93-179
	)	
Rate of Return Sharing and Lower Formula Adjustment	)	

COMMENTS OF AMERITECH

A significant portion of the NPRM is spent discussing the add back treatment of refunds under rate of return regulation. As the Commission notes, Form 492 displayed the amount of refunds associated with prior enforcement periods but effected through a reduction in current period rates, and then added those amounts to the total returns used to compute the rate of return for the current enforcement period.[4] The Commission goes on to state that it had anticipated that the "[price cap] back stop would operate in much the same way as rate of return enforcement," that "[r]ates of return would continue to be calculated and reported in essentially the same manner," and that there would be "deletion from earnings reports of information not needed under the price cap plan."[5]

Any argument that add back is required under price cap sharing because that is the way refunds were treated under rate of return regulation misses the mark. Price caps is not rate of return regulation.

> We believe that, where an incentive-based system can be designed to benefit both carriers and their customers, incentive-based regulation will produce greater benefits than adjustments to rate of return.[6]

Price cap regulation is designed as a substitute for rate of return regulation . . .[7] Further, productivity sharing under price caps does not constitute the making of a refund.

> The LECs are correct in asserting that the sharing adjustment does not apply unlawfulness, and does not constitute a penalty.[8]

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[4] Id. at ¶ 6.

[5] Id. at ¶ 8.

[6] In the Matter of Policy and Rules concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, FCC 90-314 (released October 14, 1990) ("SRO") at ¶ 40.

[7] In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Further Notice of Proposed Rulemaking, FCC 89-91 (released April 17, 1989) ("SFNPRM") at ¶ 573.

[8] In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Order on Reconsideration, FCC 91-115 (released April 17, 1991) ("Reconsideration Order") at ¶ 102.

We also reject the argument that we cannot include interest unless we characterize the sharing adjustment as a refund of over-earnings.[9]

Sharing is intended as a means of sharing prospective productivity gains, and not a refund mechanism.[10]

The differences between sharing and refunds are clear:

Refunds:

- Result from rate of return, cost-plus regulation
- Are retrospective in nature
- Indicative of past unlawful rates
- Exclude earnings from interexchange services
- Amount refunded is unaffected by future demand

Sharing:

- Results from incentive regulation
- Is prospective in nature
- Is a means of sharing productivity achievements
- Results from a legal rate structure
- Includes earnings from the interexchange basket
- Total amount shared is affected by future demand
- Results in the reduction in the opportunity to price services at a higher level, but may or may not result in a reduction of rates -- i.e., sharing lowers caps but does not necessarily result in a dollar-for-dollar benefit to customers

The fact that Form 492 had a line for refunds is irrelevant in this context. First, as noted above, sharing does not constitute a refund, so it does not follow that sharing amounts should be included in that line. Second, the fact that the refund line was not deleted with the implementation of price caps as requiring irrelevant information is not evidence that sharing was intended to be treated like a refund for add back purposes. The line can be used for traditional refunds that price cap LECs can be compelled to make -- e.g., for "over billing" in pre-price cap years -- which would, presumably, be treated in the traditional add back fashion.

B. The Add Back Of Sharing Amounts Is Not An Integral Or Necessary Part Of Price Cap Regulation.

[9] Id. at ¶ 105.

[10] Id. at n. 148.

The Commission has articulated three findings that it believes support incorporation of add back as part of the price cap sharing mechanism. None of these observations, however, support a finding that add back is an integral or necessary part of the price cap sharing mechanism.

1. Lack of add back does not hide the relationship between rate of return and productivity growth.

The Commission notes that, under price cap regulation, changes in rate of return each year are used as a surrogate measure of productivity growth relative to the price cap target. The Commission goes on to claim, however, that the amounts of sharing or lower formula adjustment implemented in one year relate to productivity performance in a prior year and that failure to add back those adjustments hides the relationship between rate of return and productivity growth.[11] That is not the case. Sharing is not a refund that relates to a prior year. Rather, sharing can best be described as the forward-looking adjustment of the price cap LEC's productivity target as a result of the LEC's past productivity performance. Given that fact, adding back the sharing amount actually distorts and hides the relationship between productivity performance (as measured by earnings) and the new price cap target for the year in which the sharing took place.

2. The "see-saw" effect is not objectionable.

The Commission notes that, all other things being equal, without add back "see-saw" variations in earnings can take place even if a carrier's costs remain the same.[12] The middle example on the first page of Appendix A of the NPRM notes that the company in question reports a different rate of return each year even though its underlying costs did not change. However, it reports a different rate of return each year because its revenues are different each year. Moreover, the variation is dampened each succeeding year.

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[11] NPRM. at ¶ 11.

[12] Id. at ¶ 12.

Exhibit 1 to this filing shows that the effects of not "adding back" -- i.e., basing sharing on actual rates of return -- are not as erratic as the Commission's example suggests. Scenario 1 extends the Commission's see-saw example an additional two years to show that the effect stabilizes naturally. Moreover, scenario 2 shows that under the split tariff/sharing year situation actually faced by price cap LECs, the sharing variations are much smaller and subside more quickly. Both of these scenarios assume that the LEC will raise rates to match index increases. Scenario 3, on the other hand, demonstrates a more realistic view that, due to market pressure, LECs are practically constrained from raising all rates to match index increases. In this example, it is assumed that, once lowered due to sharing, rates for Traffic Sensitive, Special Access, and Interexchange services will not be raised the following year even though the index goes up. Sharing in this case, shows a steady asymptotic decrease to match the LEC's decreasing revenues and returns.

3. Add back is not necessary to keep rates of return reasonable.

The Commission's final observation, that add back is necessary to preclude earnings outside the range of reasonableness,[13] is puzzling. If a carrier's earnings exceed 16.25% (assuming a 3.3% total productivity offset), regardless of how it is calculated, sharing will be 100% of the amount in excess of 16.25%. Moreover, under price caps, there is no maximum rate of return. Earnings over 16.25% will be shared 100% the next tariff year via reductions to the carrier's price cap (not necessary to its rates), so that, in economic reality, even with add back, a carrier's effective rate of return after sharing may be well above 14.25%.

Also, the Commission's view that unadjusted rates of return would permit rates of return that are, on average, 0.2% higher at the upper end is incorrect in a real economic sense. In the Ameritech example cited by the Commission in footnote 11, Ameritech actually earned 12.79% in 1992. That is the amount that was available either to distribute to investors or to reinvest in the business. An add back adjustment of $9.1 million that would raise the apparent rate of return to 12.99% would be effectively an accounting fiction. That adjustment would not

[13] Id. at ¶ 13.

make shareholders "richer" by that amount. Thus, add back merely distorts the actual earnings of the price cap carrier -- giving them the appearance of being higher than they really are. The Commission itself stated that, since sharing is not a refund, parties might well argue that the appropriate measure of sharing is a price cap carrier's "actual" earning (i.e., without add back).[14] That is, in fact, the case.

4. Further distortions of add back.

In the price cap orders, the Commission made it abundantly clear that sharing was to be regarded as a "one-time reduction in the PCI for the next rate period."[15] The distorting effects of add back, however, can result in sharing well beyond the one-year period. Consider a simple example in which a LEC (choosing a 3.3% total offset) earns above 12.25% in year one. Assume also that the LEC would earn just under 12.25% without add back for the second and subsequent years. With an add back, the sharing amount caused by the earnings in year one would throw the LEC into sharing due to year two's earnings (year two's actual earnings plus year one's add back). This add back originally caused by earnings in year one would also push year three's and subsequent years' actual earnings into sharing levels as well. Thus, the add back for just one year's sharing amount could affect an indefinite number of year's rates -- something clearly not intended by the Commission's price cap order.

Not only would add back conflict with the Commission's position that sharing only affects rates for the next rate period, but also more than 50% of year one's earnings above 12.25% would be shared beyond the next rate period. In the next rate period, 50% of the earnings would be shared. However, as shown above, a portion of year one's earnings would be shared in year three, four and every year beyond. Added together much more than 50% of year one's earnings above 12.25% would be shared over subsequent years.

[14] Id. at ¶ 14.

[15] SRO at ¶¶ 124, 136.

II. IF ADD BACK IS ADOPTED, CREDIT SHOULD BE GIVEN FOR BELOW-CAP RATES.

Since sharing under price caps operates only directly on the caps themselves, sharing may or may not find its way completely into the pockets of the ratepayer -- depending on whether and how much rates have to be lowered as a result of the cap changes. If the Commission decides that price caps requires the add back of sharing amounts, the add back amount itself should only represent the amount of rate reduction due solely to sharing. For example, if the API is $5 million below the PCI prior to a sharing adjustment of $8 million, rates would be required to be reduced by $3 million. The add back amount, if any, should be $3 million not $8 million, since that is the amount by which sharing reduced rates. Moreover, as the Commission noted, by charging below-cap rates, the LEC has already passed through some rate reduction by pricing below the cap. Allowing credit for below-cap rates would encourage carriers to charge lower rates in the first instance.[16] In the example, if sharing caused a reduction of $3 million, then it is that amount that should be added back, regardless of the index reduction that took place.

Moreover, if the Commission does require add back, it should not include, in the add back amount, interest that was included in the sharing. Interest, as the Commission has noted, is designed to reimburse ratepayers for the opportunity cost of the delay in sharing of the benefits of the LEC's productivity gains. Ratepayers have already received the benefit of the interest amount during the period when the sharing adjustment was in effect. If the interest amount is included in the add back amount, portions of this interest amount would be given back again in future sharing periods. Thus, inclusion of this interest payment in the calculation of add back is not appropriate.

Furthermore, regarding the imposition of new interest on the incremental increase to the new sharing amount due to the add back amount, the add back amount represents revenue

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[16] Choosing the 4.3% productivity factor is not a perfect substitute for choosing to price below cap in certain service categories. The 4.3% productivity factor requires an across the board rate reduction that has a permanent effect on the PCI. That may not make good business sense, depending on the market place. Thus, LECs that price below the cap should not be penalized for not electing a higher productivity offset when their lower rates still benefit customers.

that was never received or earned by the LEC. Therefore, there is no opportunity cost to the ratepayer because the LEC never collected this money from the ratepayer. Thus, it logically follows that no interest should be added to any incremental sharing amount due to add back.

In light of the above, Ameritech proposes the following method of calculating the add back amount, if add back is ordered by the FCC:

Step 1: Calculate dollar gap between API and PCI as of June 30 (last day of preceding tariff year) for each basket.

Gap = [(PCI as of 6/30) / (API as of 6/30) - 1] x "R" value

In the case of the determining the "add-back" amount for the sharing that is implemented on July 1, 1992, the PCI and API as of June 30, 1992 and the "R" value used in the 1992 annual filing (1991 demand times the rates in effect when the PCI was last updated -- prior to 7/1/92) is used.

For the Common Line basket, the actual CCL rates are compared to the maximum allowable CCL rate (CCLMOU).

When calculating the "add-back" amount for subsequent years, first adjust the existing PCI to reverse the prior sharing amounts.

Step 2: Calculate the new sharing amount based on the base period earnings prior to the inclusion of the "add-back" amount.

In this case the base period is 1991. Interest is included.

Step 3: Allocate the new sharing amount among baskets.

Step 4: Calculate the difference between each basket's new sharing amount and the gap between the API and PCI.

If the PCI/API Gap is greater than the new sharing amount, then "add-back" = 0.

Step 5: "Add-back" amount for the next two annual filings.

The result from Step 4 represents the change in revenue that will be caused solely by sharing. The incremental sharing amount due to the revenue "add-back" is equal to 50 percent of the amount in Step 4 (divided by 1.1125 to remove the interest), assuming the LEC's rate of return is between 12.25 and 16.25 percent. Since the sharing amount is implemented on July 1, only half of this revenue reduction occurs in the current year, and the remaining half occurs in following year. Therefore, the incremental sharing due to "add-back" of the sharing implemented on July 1, 1992, is added to sharing amounts in equal portions (25 percent of the amount from Step 4 divided by 1.1125 -- 50 percent sharing times six-month portions) in the 1993 and 1994 annual filings. No interest on this incremental sharing amount

		Common Line	Traffic Sensitive	Special Access	Inter-exchange	Total
(1)	PCI (6/30/92) (Max. Prem. CCL)	.009315	97.2297	99.7719	100.1535	
(2)	API (6/30/92) (Actual Prem. CCL)	.009315	96.8271	97.5588	82.5140	
(3)	"R" Value ($Mil) (1992 Filing)	1001.5	877.1	325.7	76.9	
(4)	New Sharing ($Mil) (7/1/92)	7.1	7.6	2.9	0.5	18.2
(5)	PCI/API Gap ($Mil) [(1)/(2)-1]x(3)	0.0	3.6	7.4	16.4	
(6)	Required Rate Change Due Solely to Sharing ($Mil) (4)-(5), 0 if (5)>(4)	7.1	4.0	0.0	0.0	
(7)	Required Rate Change Less Interest ($Mil) (6)/1.1125	6.4	3.6	0.0	0.0	10.0
(8)	Total Incremental Sharing Due to "Add-Back" ($Mil) 7x.50	---	---	---	---	5.0
(9)	Incremental Sharing for 1993 Filing ($Mil) (8)/2	---	---	---	---	2.5
(10)	Incremental Sharing for 1994 Filing ($Mil) (8)/2	---	---	---	---	2.5

The incremental sharing for the 1993 and 1994 filings are allocated among baskets based on each basket's share of revenue for the base period.

III. CONCLUSION.

Add back has no place in price cap regulation. The rate of return mechanism that required the add back of refund amounts is not applicable to sharing. Moreover, add back would only cause distortions -- hiding the relationship between a LEC's actual earnings and its new productivity target and causing a continual sharing effect that goes well beyond the one-year period and above the 50% amount (for earnings between 12.25% and 16.25%) originally contemplated by the Commission.

As the Commission noted in adopting price caps for LECs:

In sum, the telecommunications environment LECs face has changed radically since the mid-1960s. And while we have made improvements in our ability to administer rate of return rules, the basic, underlying regulatory structure lying at the heart of our rules remains unchanged. We are concerned that, particularly for the largest LECs, the system of regulation we currently employ does not serve to sharpen the competitiveness of this important segment of the industry at a time when markets for telecommunications goods and services are becoming increasingly competitive, both nationally and internationally. . . . We do not intend to ignore an opportunity to reshape our regulatory system in a manner that benefits us in the international marketplace while also improving the productivity of the LEC industry and benefiting ratepayers.[17]

On the other hand, the Commission also found:

By reducing the range of earnings permitted under the backstop, add back does reduce the efficiency incentives [of price caps].[18]

The Commission should avoid taking a step backward in incentive regulation and, instead,

EXHIBIT 1: ACTUAL EFFECTS OF SHARING

SCENARIO 1: EXTEND SECOND EXAMPLE IN APPENDIX A TWO MORE YEARS									
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6			
Base Revenues	2,425	2,425	2,425	2,425	2,425	2,425			
Sharing Adj.	0	-100	-50	-75	-63	-69			
Actual Revenues	2,425	2,325	2,375	2,350	2,363	2,356			
Expenses	1,000	1,000	1,000	1,000	1,000	1,000			
Return	1,425	1,325	1,375	1,350	1,363	1,356			
Rate Base	10,000	10,000	10,000	10,000	10,000	10,000			
ROR	14.25%	13.25%	13.75%	13.50%	13.63%	13.56%			
Sharing for next period	-100	-50	-75	-63	-69	-66			
SCENARIO 2: SCENARIO 1, ADDING TARIFF/CALENDAR YEAR EFFECTS									
	Year 1	<----------Year 2----------->			<----------Year 3----------->				
		1st Half	2nd Half	Total	1st Half	2nd Half	Total		
Base Revenues	2,425	1,213	1,213	2,425	1,213	1,213	2,425		
Sharing Adj.	0	0	-50	-50	-50	-38	-88		
Actual Revenues	2,425	1,213	1,163	2,375	1,163	1,175	2,338		
Expenses	1,000	500	500	1,000	500	500	1,000		
Return	1,425	713	663	1,375	663	675	1,338		
Rate Base	10,000	10,000	10,000	10,000	10,000	10,000	10,000		
ROR	14.25%	14.25%	13.25%	13.75%	13.25%	13.50%	13.38%		
Sharing for next period	-100			-75			-56		
	<----------Year 4----------->			<----------Year 5----------->			<----------Year 6----------->		
	1st Half	2nd Half	Total	1st Half	2nd Half	Total	1st Half	2nd Half	Total
Base Revenues	1,213	1,213	2,425	1,213	1,213	2,425	1,213	1,213	2,425
Sharing Adj.	-38	-28	-66	-28	-34	-62	-34	-35	-68
Actual Revenues	1,175	1,184	2,359	1,184	1,179	2,363	1,179	1,178	2,357
Expenses	500	500	1,000	500	500	1,000	500	500	1,000
Return	675	684	1,359	684	679	1,363	679	678	1,357
Rate Base	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
ROR	13.50%	13.69%	13.59%	13.69%	13.58%	13.63%	13.58%	13.56%	13.57%
Sharing for next period			-67			-69			-66

EXHIBIT 1: ACTUAL EFFECTS OF SHARING

SCENARIO 3: SCENARIO 1, ADDING REAL PRICING EFFECTS									
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6			
Base Revenues	2,425	2,425	2,365	2,335	2,308	2,289			
Sharing Adj.	0	-100	-50	-45	-33	-25			
Actual Revenues	2,425	2,325	2,315	2,290	2,276	2,263			
Expenses	1,000	1,000	1,000	1,000	1,000	1,000			
Return	1,425	1,325	1,315	1,290	1,276	1,263			
Rate Base	10,000	10,000	10,000	10,000	10,000	10,000			
ROR	14.25%	13.25%	13.15%	12.90%	12.76%	12.63%			
Sharing for									
next period	-100	-50	-45	-33	-25	-19			
	Year 7	Year 8	Year 9	Year 10					
Base Revenues	2,273	2,262	2,253	2,246					
Sharing Adj.	-19	-15	-11	-8					
Actual Revenues	2,254	2,247	2,242	2,238					
Expenses	1,000	1,000	1,000	1,000					
Return	1,254	1,247	1,242	1,238					
Rate Base	10,000	10,000	10,000	10,000					
ROR	12.54%	12.47%	12.42%	12.38%					
Sharing for									
next period	-15	-11	-8	-6					
NOTE: Base revenues for scenario 3 reflect market pressures against price increases. When PCIs are adjusted to reflect reversal of sharing each year, prices for Traffic Sensitive, Special Access									